Zacks Small-Cap Research

March 12, 2012
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Sierra Monitor Corporation SRMC-OB

SRMC: –Preparation for Largest Order Ever; OUTPERFORM

Current Recommendation	**Outperform**
Prior Recommendation	Neutral
Date of Last Change	02/23/2012
Current Price (03/09/12)	$1.39
Six- Month Target Price	**$2.50**

OUTLOOK

Sierra Monitor Corporation designs and develops hazardous gas monitoring devices for the protection of personnel and facilities in industrial work places. Through its subsidiary FieldServer Technologies the firm has branched into protocol translation technology, which enables machine to machine (M2M) communication in energy and building automation applications. This high growth business should complement the gas detection business, while not sacrificing market or margins. FieldServer should see a tailwind as a result of the push toward zero net energy building designs. We see value in the shares of SRMC.

SUMMARY DATA

52-Week High	**$1.90**
52-Week Low	**$1.25**
One-Year Return (%)	**-0.67**
Beta	**0.19**
Average Daily Volume (sh)	**219**
Shares Outstanding (mil)	**10**
Market Capitalization ($mil)	**$15**
Short Interest Ratio (days)	**N/A**
Institutional Ownership (%)	**0**
Insider Ownership (%)	**63**
Annual Cash Dividend	**$0.00**
Dividend Yield (%)	**0.00**
5-Yr. Historical Growth Rates	
Sales (%)	**N/A**
Earnings Per Share (%)	**N/A**
Dividend (%)	**N/A**
P/E using TTM EPS	**12.6**
P/E using 2012 Estimate	**8.2**
Zacks Rank	**3**

Risk Level	**Moderate**
Type of Stock	**Small-Blend**
Industry	**Industrial Services**

ZACKS ESTIMATES

Revenue
(in millions of $)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	3.2 A	2.9 A	3.3 A	3.2 A	12.6 A
2010	2.9 A	3.5 A	3.7 A	4.2 A	14.3 A
2011	4.2 A	4.0 A	3.8 A	3.5 A	15.5 A
2012	6.2 E				18.5 E

Earnings per Share
(EPS is operating earnings before non recurring items)

	Q1 (Mar)	Q2 (Jun)	Q3 (Sep)	Q4 (Dec)	Year (Dec)
2009	$0.00 A	$0.00 A	$0.01 A	$0.01 A	$0.02 A
2010	$0.00 A	$0.03 A	$0.03 A	$0.03 A	$0.09 A
2011	$0.04 A	$0.03 A	$0.03 A	$0.01 A	$0.11 A
2012	$0.07 E				$0.17 E

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WHATS NEW

Solid Quarter at Sierra Monitor as it Prepares for Largest order Ever

On March 6, 2012, Sierra Monitor Corporation, reported financial results for its fourth quarter and full year ended December 31, 2011.

Sierra Monitor reported mixed results with year over year fourth quarter revenues falling $647,963 or 15.4 percent, to $3.572 million from $4.220 million for the comparable quarter of 2010.

The Company's fourth quarter 2011 GAAP net income dropped 60.4 percent or $219,090 to $143,388 from $362,478 during the three months ended December 31, 2010. The decrease in net income for the quarter was primarily due to the decrease in revenues as well as a marginal increase in operating expense which was slightly offset by higher margins.

Total operating expenses increased by $47,361 or to 51.9 percent of revenues to $1.854 million from $1.807 million or 42.8 percent of revenues for the three months ended December 31, 2011.

Still, gross margin increased 70 basis points year over year from 57.6 percent to 58.3 percent for the three months ended December 31, 2011. Non GAAP net income during the quarter dropped sharply from $386,907 for the fourth quarter of fiscal 2010 to $76,606.

Based on a weighted average number of basic common shares of 9.901 million, both GAAP and non GAAP basic net income per share resulted in $0.01 per share for the quarter. This was down from GAAP and Non GAAP basic net income per share of $0.03 on a weighted average number of basic shares of 11.187 million during the three months ended December 31, 2010.

For the full year ended December 31, 2011, year over year revenues improved by 7.9 percent or $1.135 million to $15.529 million from $14.393 million for fiscal 2010.GAAP Net income for the full year improved by $221,017 year over year to $868,947 for the twelve months ended December 31, 2011. This compares to $647.930 for the comparable twelve months ended December 31, 2010.

Total operating expenses fell to 49.9 percent of revenues or $7.751 million from $7.279 million or 50.6 percent of revenues for the full year ended December 31, 2011. Similarly, gross margin for the full year improved by 70 basis points to 59.2 percent compared to gross margin of 58.5 percent for the full year ended December 31, 2010. Non GAAP net income during the year improved by 14.9 percent to $1.123 million from $977,413 for the full year ended December 31, 2010.

Based on a weighted average number of basic common shares of 9.899 million, GAAP basic net income per share resulted in $0.09 per share for the year. This was up from GAAP basic net income per share of $0.06 on a weighted average number of basic shares of 11.389 million during the fiscal year ended December 31, 2010.

Sierra Monitor's balance sheet remained strong with cash and of equivalents of $1.212 million and working capital improving by $912,673 to $5.628 million for the period ended September 30, 2011. Likewise, the Company had trade receivables of $1.648 million as of December 31, 2011 and Days Sales Outstanding was 37 days.

Still, it should be noted that while net inventories increased by $1.803 million year over year and cash and equivalents fell by $433,007 year over year, the Company received an over $2.5 million order in the

third quarter that required a significant year-end increase in inventory and a large demand on cash.

Finally, while financial results were mixed, during the quarter the Company received a large order from a new international manufacturer of electrical and electronic products customer, to develop and supply a FieldServer data gateway solution to integrate lighting controls into building automation systems.

Similarly, Sierra Monitor received orders, during the fourth quarter, from a major truck leasing company to supply gas detection in multiple CNG vehicle support centers.

Equally, the Company reported that during the three months it expanded its FieldServer presence at the new World Trade Center as well as a gas detection system at a Texas independent school district.

Sierra monitor also shipped gas detection systems to customers in Saudi Arabia and Singapore for retrofitting of off-shore platform service vessels as well as completed development and shipped initial production orders of FieldServer gateways for interfacing shade controls into building automation systems during the fourth quarter.

Last, Sierra Monitor reported that it anticipates shipment of the order for gas and fire detection instruments for a petroleum pipeline booster station in Kuwait in the first quarter of 2012.

Seeds of this Stepping Stone Contract Were Sown Long Ago

With their primary gas detection products Sierra Monitor Corporation [SRMC] has established a reputation of supplying high quality instrumentation and control systems for domestic industrial markets. Several years ago the company began releasing new products that further satisfy domestic requirements while also meeting specifications for international projects including the Middle East. With the products released and various third party approvals underway SMC ventured to open a sales office in Dubai beginning the sometimes arduous task of obtaining specific approvals from the key Middle East Companies including Aramco, ADCO (Abu Dhabi Oil), Kuwait Oil and others.

The strategy began paying off in 2010 when several project sales were complete, each in the area of $150K to $250K. The recent announcement that the company has now received an order for delivery in 2011 of $2.5 million of gas and fire detection equipment certainly reinforces that the company has established itself as a player in the large scale project market. The company has the strength of products, size of facility and the strength of balance sheet to undertake this order and continue the Middle East successes. We feel this will become a stepping stone contract.

The World Onshore Pipelines Report 2011-2015 forecasted US$193 billion will be spent on onshore pipeline projects worldwide through to 2015. Many countries, especially in Asia and the Middle East, have specific national priorities for pursuing refining projects. China is going ahead with its refining projects to meet its surging domestic demand for refined products and to reduce dependence on imports. The Middle East is investing heavily to become a major petroleum products export hub by utilizing its domestic heavy and sour crude as well as satisfying its increasing domestic light distillate demand. (Oil and Gas Chronicle)

Cisco EnergyWise

According to Cisco, in response to energy costs, environmental concerns, and government directives, there is an increased need for sustainable and "green" business IT operations. More than 70 percent of electricity consumed in the United States is used in office buildings. However, inefficient use is leading to energy wastage. For example, Department of Energy (DoE) estimates suggest that PCs left on are in use only 9 to 15 percent of the time. Consequently, there is renewed focus in making sure of not only the procurement of energy-efficient equipment, but also judicious usage and proactive monitoring. Enter Cisco EnergyWise Architecture. This is technology architecture added to existing switching and routing portfolios that is able to,

- Measure power consumption consumed by each device in the network.
- Analyze this data in order to make decisions on cost saving policy actions.
- Enact policies to optimize the power consumption of the building.

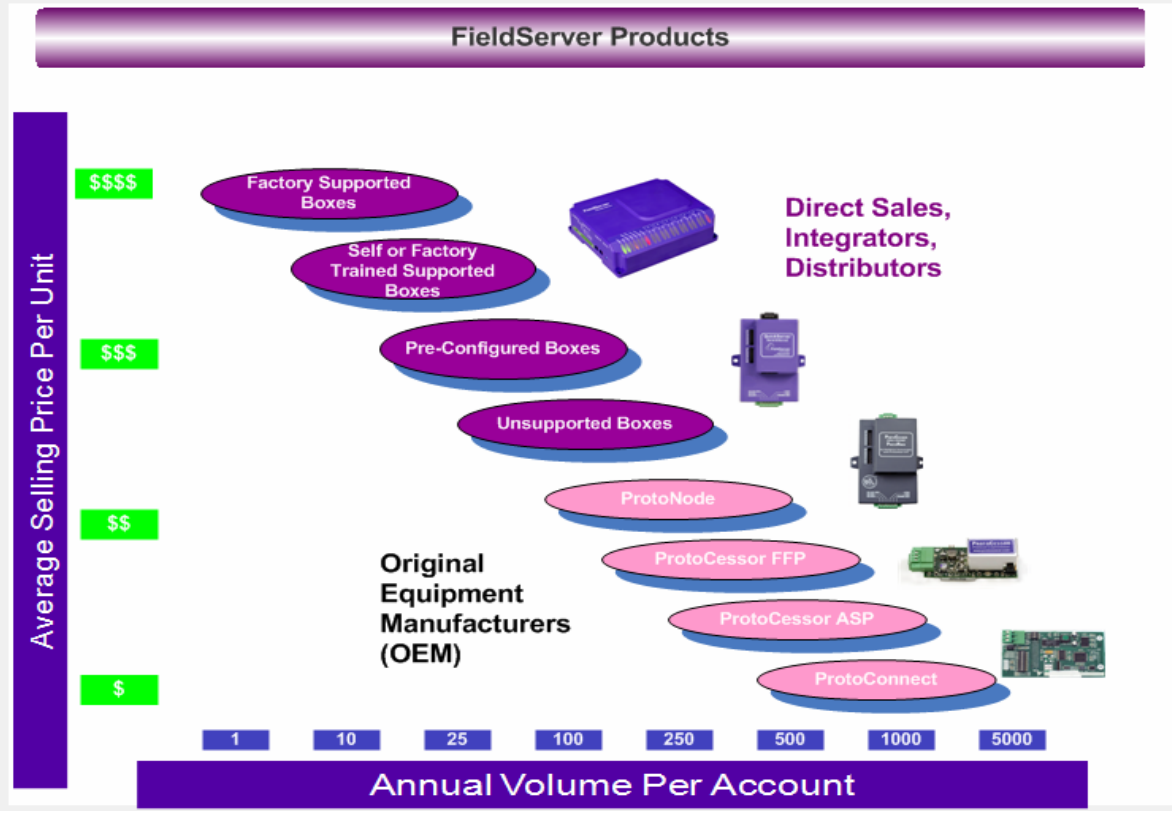
Sierra Monitor's FieldServer division has developed a translator to allow energy management connections between Cisco's EnergyWise protocol and external devices including power meters, lighting controls and other building automation devices. The translator, which is currently under test, opens opportunities for Cisco to increase the benefit of their EnergyWise offering and thereby expanding the market for FieldServer products.

***Source for Cisco EnergyWise System is from company brochure**

Beyond the Obvious

As the push toward energy efficiency continues to gain momentum, building automation remains a focus for the real estate community, building owners and campuses. Large automation suppliers depend upon gaining monitor and control access to more and more devices in the building. These devices range from standby generators to window shares, from lighting to power management at the work cubicle level. When the devices lack the appropriate communication protocol FieldServer products fill the need by translating the device protocol to the building's data back-bone protocol.

FieldServer supplies packaged protocol translation solutions (gateways) directly to building automation integrators and also through other manufacturer's sales channels where the addition of the protocol solution adds value to the overall offering. As price pressure eases unit costs for gateways downward, the trend is for integrators to find more uses for the gateway increasing the number deployed in each project.



FieldServer also supplies the same protocol translation capabilities in formats that can be purchased by OEM's and integrated into their offerings. The OEM products are sold under the ProtoCessor product name. As the manufacturer's note more and more interface requirements through their sales channels they identify revenue opportunities to either increase their selling prices or position their products in a more unique manner. FieldServer's ProtoCessor product is the fastest growing product line in the company as more OEM's recognize the opportunity and learn that the ProtoCessor products allow a fast, reliable, route to market. FieldServer's extensive knowledge of M2M communication protocols allows the OEM to enter a product arena that would otherwise represent high technological barriers and risks.

INVESTMENT THESIS

Sierra Monitor Corporation designs and develops hazardous gas monitoring devices for the protection of personnel and facilities in industrial work places, environment monitoring and control systems for remote telecom site management and protocol translation gateways that allow disparate machines to communicate with each other. While gas detection and telco site management products provide a stable business base the newer protocol gateway business is expected to accelerate overall growth of SRMC.

Primary product groups:

- Gas Detection
- Telecom Site Management
- Protocol Translation Gateways

The firm should capitalize on the expanding worldwide demand for cleantech knowledge-based products and services that improve operational performance, productivity, efficiency and safety in building

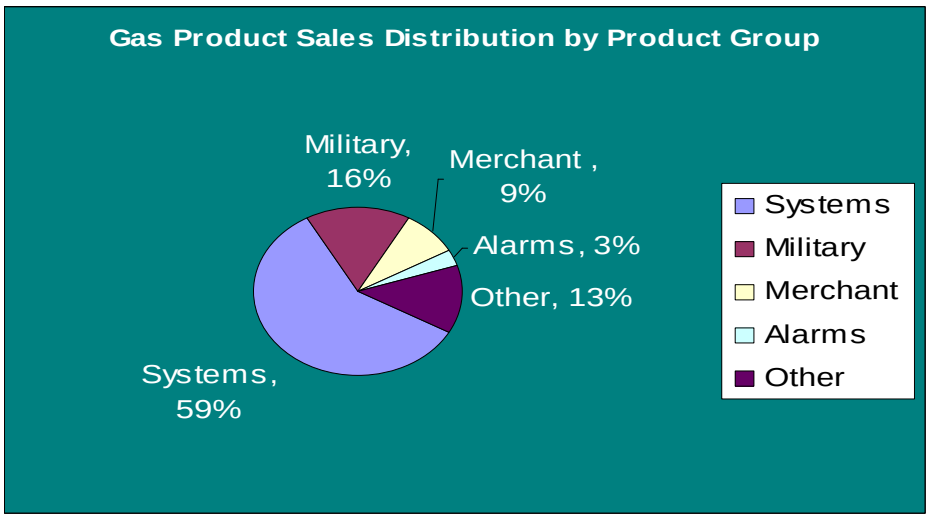
automation, industrial and military applications, while reducing demands on resources and energy consumption.

Gas Detection

Sierra Monitor's hazardous gas and fire detection systems, including combustible gas monitors, toxic gas monitors and flame detectors are used in industrial markets worldwide. The gas detectors range from basic gas monitors with alarms to complete plant-wide intelligent hazardous gas and flame detection systems utilizing digital communications between the sensors and the controller and further to the plant Distributed Control System. Taking the Sentry Gas Detection System as an example, it provides a comprehensive plant-wide controller/sensor system for monitoring combustible gas, oxygen deficiency and toxic gases to maintain safety in a plant. The flexibility of Sentry enables the customer to design a safety system that meets the firm's specific needs.

Product	Industry	Use	Price
Integrated Systems	Process & Muni Plants	Integrated Controller and Sensors with multiple communication choices	Highest
Unitary	Factories & Storage Areas	Alarm and Control in Field Device	High
Commodity Gas	Re-sellers/	Digital and Analog Solution	Moderate
Alarm Systems	Virtually Any Market	End users provide control infrastructure	Low

These systems utilize features such as recorded event information, graphical displays on central computers and web server displays to allow users to identify hazards and problems before they evolve into incidents which, could cause production delays and may prompt evacuation of personnel and potentially even cause property damage and physical injury.



Custom Systems

Sierra Monitor designs and fabricates gas detection systems customized for clients applications. The company maintains a UL (Underwriters Labs) certified design process that allows complete systems to leave the factory with UL marking. These systems may incorporate special enclosures, alarm devices, web interfaces and other options. Applications of customized system include the following.

- Duct monitoring of Silane in semiconductor tools

- Combustible gas monitoring in alternate fuel school buses
- Monitoring bus barns for alternative fuel (CNG) vehicles
- Ammonia monitoring in ice cream plant
- Combustible gas monitoring in telecommunications vaults

Telecom Site Management

SRMC also supplies microprocessor-based environment control products to the telecommunications industry. The control products are used to monitor temperature, gas, smoke and other environmental and security conditions in remote structures such as DSL distribution nodes, fiber optic booster stations and cell-tower site buildings. Environment controllers integrate various functions which would otherwise require discrete controls and alarm handling.

All segments of the telecommunications industry, land line, wireless, cable and satellite, employ vast networks of highly sophisticated communications equipment to deliver their services rapidly and reliably to their customers. Much of this equipment is deployed in remote, largely unmanned sites. Therefore it is natural that the firm offers a comprehensive array of Telecom Site Management Products. Each is microprocessor based and is designed in form, fit and function for the intended application and for the type of structure into which it will be deployed.

The equipment in these sites will vary, depending upon the signal and data transmission medium: copper, fiber, coax, RF. The structures housing this equipment will also vary, depending upon location and local building, zoning and environmental regulations. Common, however, to all equipment and structure types is the requirement for support elements that are critical to uninterrupted site availability and uncompromised site safety and security. Critical support elements include commercial power, HVAC, generators, DC plant and batteries and environmental sensors.

Over the next 15 to 20 years, copper access networks worldwide will be largely replaced by a fiber access network, creating massive opportunities for vendors, network builders, and service providers. The most important catalyst for this change is a growing perception that copper access networks will soon no longer be able to meet the ever-growing consumer demand for bandwidth, driven mainly by the Internet, IP, and the many services running over it. At the same time, competition to move customers onto complex service packages that include video is leading some to conclude that they must be first to deploy fiber, pre-empting or frustrating future competition.

Fieldserver Technologies

FieldServer Technologies consist of the Fieldserver and ProtoCessor business units. This technology targets commercial buildings infrastructure and essentially makes products that provide interoperability from device to enterprise networks. The result is the firm has a grasp on everything from energy efficiency and automation to roof-top air conditioning and lighting controls.

Research and spending over the next several years will focus on “zero net energy” building designs. The WBCSD (World Business Council for Sustainable Development) identified buildings as one of the five main users of energy where “mega trends” are needed to transform energy efficiency. They account for 40% of primary energy in most countries covered by this project and consumption is rising. The International Energy Agency (IEA) estimates that current trends in energy demand for buildings will stimulate about half of energy supply investments to 2030. If building site energy consumption in China and India grows to current US levels, China’s and India's consumption will be respectively about four and seven times greater than they are today. Energy consumption will grow dramatically without action to improve energy efficiency substantially. The construction boom, especially in China, is increasing energy demand significantly, but economic development and other factors are adding to the challenge because they also increase buildings’ energy needs.

SRMC sells several Fieldserver products to both original equipment manufacturers (OEMs) and through direct sales to integrators and distributors. From its low average selling price ProtoConnect which is targeted at companies that have a standard proprietary communications interface to its high margin X30 Linux based platforms, the firm provides Fieldserver products that cater to virtually any firm or building in the several industries.

Further legacy devices are now being linked to central sources. This enables the firm to provide a platform for remote monitoring and management. Therefore growth in this area is two-fold. It will not only come from new sales, but also from firms wishing to tie legacy products into a single system. FieldServer has become a growing piece of the solution in recent years. In 2009, combined revenue from sales of FieldServer and ProtoCessor products was approximately 45% of sales compared to approximately 40% in 2008 and 37% in 2007.

KAUST

King Abdullah University of Science and Technology (KAUST) is located on the coast of the Red Sea approximately eighty kilometers north of Jeddah in Saudi Arabia. Construction of the university involved a multi-billion dollar effort by a consortium of engineering and construction contractors. The entire campus, including nineteen massive academic buildings, hundreds of town center buildings and over a thousand student and faculty buildings is monitored and controlled via a system known as ICAS (Inter Campus Automation System). ICAS tracks every electrical and security device in the infrastructure including lights, window shades, motion sensors, fire alarm panels, computer screens, temperatures, water flow, and many other devices and parameters.

During construction the ICAS integrator used Sierra Monitor FieldServers for two primary tasks. The first was to interface to all academic building lighting panels. The second task was to interface to hundreds of fire panels distributed throughout the academic buildings, town center and residences. FieldServer supplied the interface products through a series of orders beginning in the second half of 2009 and continuing to the present including a large order shipped in Q4 of 2010. In addition to the supply of products FieldServer provided fee based remote technical support and also supplied three application engineers for a total of ten weeks of on-site support in Saudi Arabia. Due to the fact that all equipment used at KAUST must have a communication protocol known as BACnet it is very likely that there are many more FieldServer devices deployed in equipment at the university but sold through OEM channels to equipment manufacturers.

The KAUST project represents an excellent example of how FieldServer products and services can offer very high value technical solutions in multifaceted monitoring and control applications.

VALUATION

SRMC remains well positioned to achieve solid revenue growth and operating leverage given the trend toward to energy efficient buildings with machines that communicate with one another. We feel the company's competitive advantage is two fold. It connects not only new products in machine to machine (M2M) communication but also legacy products. The faster growing FieldServer Technologies subsidiary is an excellent complement to the high margin gas detection business used in industrial markets world wide. Further KAUST remains a model for future business and the balance sheet is a source of strength.

The company is trading at a reasonable 8.2x 2012 estimated EPS. We value the company based on the average of our P/E multiple (14.7x 2012 estimated EPS) and our two stage intrinsic model.

The intrinsic value is essentially a sum of the company's future earnings, minus any long-term debt. (0 in Sierra's case) Dividing the intrinsic value by the number of shares outstanding yields an intrinsic stock price. We used the following inputs:

- A 10-year period with an earnings growth rate of 12.0% (average forecast) and a discount rate of 11.5%.
- A continuing period assumed to go on forever, with earnings growing at 5% and a discount rate of 10.4%.

With these inputs we arrive at a target price of $2.50.

RISKS

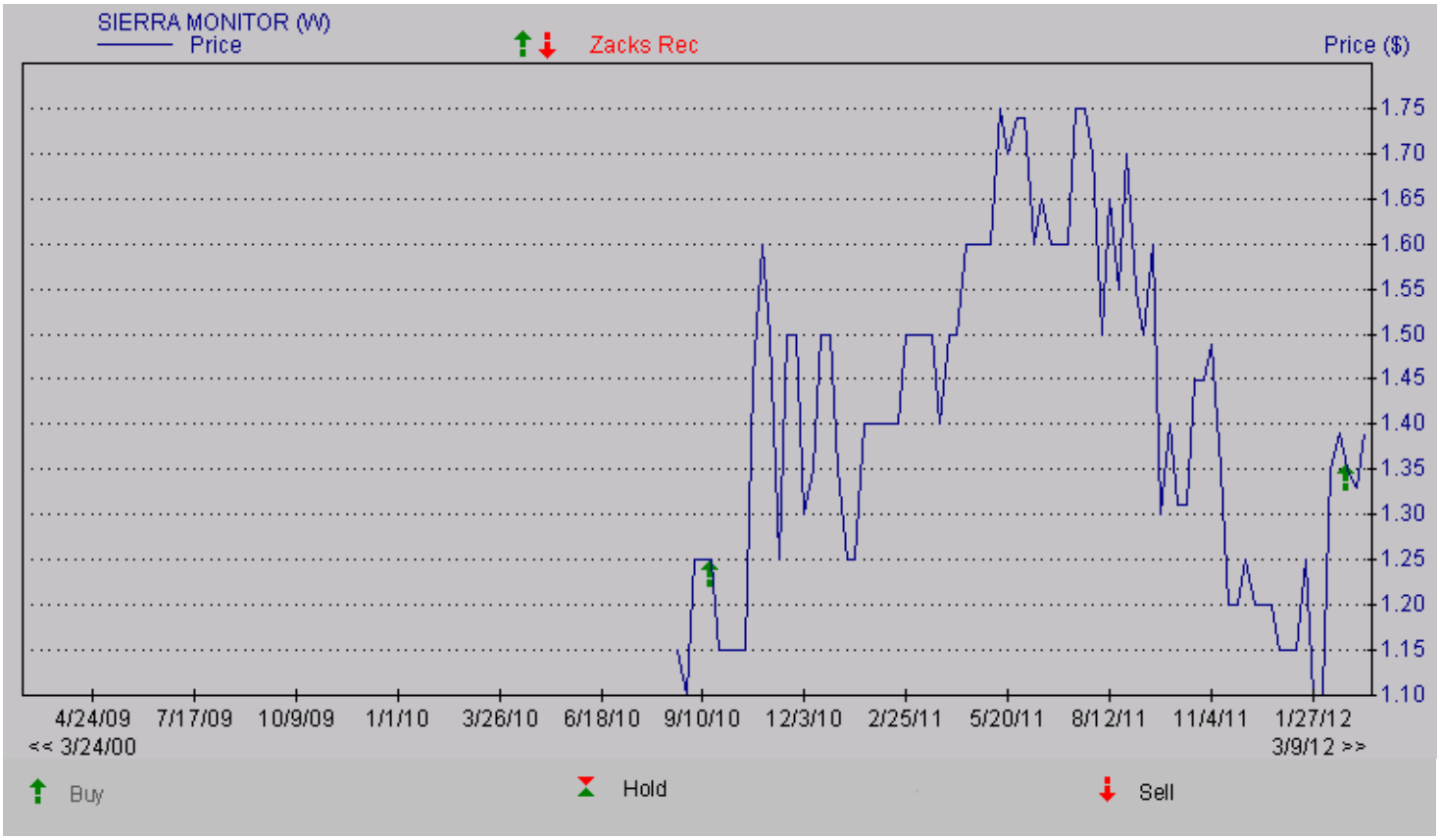
- While the overall world economy and markets have rebounded, the possibility of a double dip or a slow growth environment remains.
- Future growth depends on the adoption rate of technology and a delay could result in revenues and earnings dropping below expectations.

PROJECTED INCOME STATEMENT & BALANCE SHEET

INCOME STATEMENT ($ Mil)	Dec-10 Q4 10	Mar-11 Q1 11	Jun-11 Q2 11	Sep-11 Q3 11	Dec-11 Q4 11	Mar-12 Q1 12 E	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012 E
REVENUE												
Net Revenue	**4.2**	**4.2**	**4.0**	**3.8**	**3.6**	**6.2**	**12.97**	**13.75**	**12.73**	**14.39**	**15.53**	**18.50**
Sequential Growth		*-1%*	*-4%*	*-5%*	*-6%*	*74%*						
OPERATING EXPENSES												
Cost of Revenues	1.79	1.66	1.63	1.56	1.49	2.57	5.24	5.60	5.11	5.97	6.3	7.5
% of Revenue	*42.3%*	*39.8%*	*40.9%*	*41.1%*	*41.7%*	*41.5%*						
Gross Profit -	**2.4**	**2.5**	**2.4**	**2.2**	**2.1**	**3.6**	**7.73**	**8.15**	**7.62**	**8.4**	**9.2**	**11.0**
Proforma Gross Margin	*57.7%*	*60.2%*	*59.1%*	*58.9%*	*58.3%*	*58.5%*	*59.6%*	*59.3%*	*59.9%*	*58.5%*	*59.2%*	*59.5%*
R&D + Engg	0.50	0.55	0.55	0.55	0.56	0.85	2.1	1.9	2.0	2.0	2.2	2.5
% of Revenue	*11.7%*	*13.1%*	*13.8%*	*14.5%*	*15.6%*	*13.7%*	*16.1%*	*13.9%*	*15.4%*	*13.7%*	*14.2%*	*13.5%*
SG&A	1.31	1.44	1.43	1.38	1.30	1.90	4.62	5.37	5.24	5.30	5.55	6.50
% of Revenue	*31.1%*	*34.5%*	*35.8%*	*36.4%*	*36.3%*	*30.6%*	*35.6%*	*39.0%*	*41.2%*	*36.8%*	*35.7%*	*35.1%*
GW Amort, Restructuring, other	-	-	-	-	-	-	-	-	-	-	-	-
% of Revenue												
Total Operating Expenses	1.81	1.98	1.98	1.94	1.85	2.75	6.71	7.27	7.21	7.28	7.75	9.00
% of Revenue	*42.8%*	*47.5%*	*49.6%*	*50.9%*	*51.9%*	*44.4%*	*51.7%*	*52.9%*	*56.6%*	*51%*	*50%*	*49%*
Operating Income -	**0.63**	**0.5**	**0.38**	**0.3**	**0.2**	**0.9**	**1.02**	**0.88**	**0.41**	**1.1**	**1**	**2**
Operating Margin	*14.9%*	*12.7%*	*9.5%*	*8.0%*	*6.4%*	*14.1%*	*8%*	*6%*	*3%*	*8%*	*9%*	*11%*
NON-OPERATING ITEMS												
Non operating Income/Expense	0	0	0	0	0	0	0.0	-	0.0	0	0	0
% of Revenue	*0.02%*	*0.01%*	*0.01%*	*0.01%*	*0.00%*	*0.00%*	*0.07%*	*0.00%*	*0.07%*	*0.03%*	*0.01%*	*0.05%*
Tax Provision	0.3	0.2	0.2	0.1	0.1	0.2	0.43	0.39	0.2	0	1	0
Effective Tax Rate												
Net Income -	**0.36**	**0.32**	**0.23**	**0.18**	**0.14**	**0.72**	**0.60**	**0.49**	**0.22**	**0.68**	**0.9**	**1.7**
Net Income Margin	*8.6%*	*7.6%*	*5.7%*	*4.8%*	*4.0%*	*11.6%*	*4.6%*	*3.5%*	*1.7%*	*5%*	*6%*	*9%*
Adjustments		**0.01**	**0.01**									
EARNINGS PER SHARE												
EPS - Basic	$0.03	$0.04	$0.03	$0.03	$0.01	$0.07	$0.05	$0.04	$0.02	$0.09	$0.11	$0.17
EPS - Diluted	$0.03	$0.04	$0.03	$0.03	$0.01	$0.07	$0.05	$0.04	$0.02	$0.09	$0.11	$0.17

Ken Nagy, CFA Zacks Investment Research 3/9/2012

HISTORICAL ZACKS RECOMMENDATIONS



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